SUPREME COURT, U. S.

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Supreme Court of the United States

October Term, 1969

No. 220

JEFFERSON STANDARD LIFE INSURANCE COMPANY,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITIONER'S REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

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September 5, 1969

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1.

THE SIGNIFICANCE OF THIS CASE

In its comments regarding the significance of this case, the Government's Brief (pp. 37-38) retreats from the position expressed in its brief in opposition to certiorari in *Franklin Life Insurance Co.* v. *United States,* No. 780, October term 1968, cert. den. 393 U.S. 1118.

> ". . . We would therefore not oppose certiorari even in the absence of a conflict if it appeared that present review would facilitate the final settlement of the income tax liabilities of this and other life insurance companies. . . ."

The large volume of litigation and of administrative disputes under the Life Insurance Company Income Tax Act of 1959 (the 1959 Act) has developed because of questions raised in interpreting and applying a completely new method of taxation to life insurance companies. Over a period of a great many years prior to the enactment of the 1959 Act the National Association of Insurance Commissioners ("N.A.I.C.") evolved for the life insurance industry a uniform system of accounting that took into consideration the peculiarities inherent in the life insurance business. Congress was aware of the industry accounting practices at the time of the enactment of the 1959 Act (see Government's Brief, p. 11), and many of the questions now in litigation or in controversy with the Government involve the issue as to whether, under Section 818(a), the industry accounting practices are to be followed where the Act is silent as to the specific treatment.

Taxpayer's petition for certiorari listed (pp. 16-18) the very considerable number of cases pending as of the time of the preparation of the petition involving issues arising in this case and involving other issues arising under Section 818(a). The Government contends that there is no conflict yet among the Circuits, but the vital point is that since the enactment of the 1959 Act the Supreme Court has not passed upon the issues arising in the case at bar and in many other cases despite the fact that most of the issues are of day-to-day concern and of continuing importance to the nation's life insurance companies. Income taxes of some companies for years as far back as 1958 have not yet been determined, and the disputes will increase and will continue to plague both the companies and the Government until this Court, by disposing of the basic issues that are involved in this case, lays down guidelines by which not merely the general issue of the scope

of the N.A.I.C. computations but also many of the additional disputes can be resolved. In the present state of the law no life insurance company can with any degree of assurance forecast the correct treatment to be given many of the items in its income tax returns, or make plans on the basis of what its tax liabilities will be. This, in turn, means that the State insurance regulatory authorities are unable to measure the liabilities of the companies they supervise. The present chaotic situation also creates an inordinate number of administrative problems for the Internal Revenue Service. It is submitted that this Court should decide the issues in this case in order to establish standards for interpretation of the 1959 Act.

This Court gave weight to considerations urged by the taxpayer here when it granted certiorari in the *Atlas* case, *at the request of the Government*, before there was a conflict among the Circuits. The *Atlas* case involved only one issue, whereas this case involves a number of issues of importance to the life insurance industry as a whole.

2.

LOADING ON DEFERRED AND UNCOLLECTED PREMIUMS

The Government's Brief on the loading issues contains a patent inconsistency that undermines the entire argument. While recognizing that "Congress . . . was aware of the accounting practices of the insurance industry, under which life insurance companies, in accounting for their gross premiums, include the full year's premium . . ." (p. 11), the Government then ignores the fact that Congress also had in mind the connected and correlative adjustments of the insurance industry that eliminate loading and balance the accounts. Thus, the Government relies upon the industry

practice as prescribed by the N.A.I.C. to the extent that it is in the Government's favor, and expressly disavows it to the extent that it is in the taxpayer's favor, and argues this despite the fact that the two treatments—the inclusion in income of gross deferred and uncollected premiums on the one hand, and the elimination of the loading on the other—are but two interdependent elements in a single, integrated design.

The N.A.I.C. method of handling the increase in loading on deferred and uncollected premiums had been specified since December 31, 1951. (Tr. 296) The hearings that led to enactment of the 1959 Act indicated an intent that the underwriting profit to be included in the tax base was the profit shown by the annual statement.[1] This awareness and approval by Congress of the industry practice was confirmed by the provisions of Section 818(a).

Congress intended that the Act reflect the N.A.I.C. treatment of loading on deferred and uncollected premiums since the 1959 Act did not contain any specific provisions for the handling of deferred and uncollected premiums, and thus N.A.I.C. computations pursuant to Section 818(a)

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[1] Preceding the enactment of the law, the Secretary of the Treasury, in an April 10, 1958, letter to the Chairman of the Ways and Means Committee, made the following statement:

> "We suggest that the starting point for measuring the net earnings should be the figure for 'Net gain from operations after dividends to policyholders' which appears in each company's annual statement to the State insurance departments and which summarizes the operating results for the year. This figure is based on carefully developed life insurance accounting practices which have general acceptance in the industry. Adjustments, such as those for tax-exempt interest, Federal income taxes paid, and depreciation on the insurance business property account, would conform it with general rules for computing taxable income." Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means, *Hearings on Taxation of Income of Life Insurance Companies*, 85th Cong., 2d Sess. (1958), p. 4.

govern the entire treatment of deferred and uncollected premiums, including the loading.

The Government's contention that the taxpayer's position would give it a substantial tax windfall is demonstrably groundless and fallacious. The Government states (Brief, p. 12): "In the first policy year, petitioner would take deductions for all expenses incurred during the taxable year, a full year's reserve on the policy, and the loading deduction claimed here." This sentence erroneously implies that the petitioner is getting some kind of double or excessive deduction. The fact is that the petitioner does not accrue any deductible expenses in connection with deferred and uncollected premiums; no expenses with respect to deferred and uncollected premiums are incurred so as to be properly accruable. The item of loading is simply the difference between the net valuation premium and the gross or contract premium (Tr. 289-290). *The vital point that the Government has consistently ignored in these cases is that deferred and uncollected premiums are not income at any time during the life of the policies and that there is no accrual of expense in connection with deferred and uncollected premiums.* Instead, as premiums are collected they are reported as income, and expenses incurred by the collection of premiums are deducted. Consequently, the N.A.I.C. treatment of deferred and uncollected premiums does not result in any indefinite deferral of income.

Thus, the sentence from the Government's brief quoted in the last paragraph is erroneous for the following reasons:

(a) *No* expenses are accrued or deducted on account of deferred and uncollected premiums during the year;

(b) The "full year's reserve" is the *net* valuation premum and interest thereon, although the Government's brief implies otherwise; and

(c) Loading is that portion of the gross premium remaining after the net valuation premium, and thus the end result of the annual statement treatment is that the reserve offsets exactly what is taken into income.

The Government's brief argues that there is some proportionate relationship between assets and reserves used in determining the policyholders' exclusion in the Phase I computation and, proceeding on this basis, argues that there should also be some proportionate relationship between the deferred and uncollected premiums included in assets and the reserves resulting from such premiums (pp. 13-14). There is no basis for the Government's contention (footnote 8 on p. 13) that the Phase I formula is based upon a proportionate relationship between reserves and total assets. No such proportionate relationship is provided, or even implied, in the Phase I computations. This is clear from the last sentence of Section 804(a)(1), which covers the possibility that the Phase I formula may result in policy and other contract liability requirements that *exceed* the total investment yield. Thus, instead of the Phase I formula being based upon a proportionate relationship between reserves and total assets, the formula may even apply in a situation in which reserves equal or exceed total assets. * net valuation premium on deferred and uncollected premiums that are included in assets under the taxpayer's computations, the taxpayer's position does not violate the standards of accrual accounting.

3.

UNEARNED INTEREST INCOME

Contrary to the Government's Brief (p. 19), there is a conflict between the decision of the Seventh Circuit in

* [Omitted by printer]
Since the additions to reserves are matched by the

Artnell Co. v. *Commissioner*, 400 F.2d 981 (7th Cir. 1968), and the decision of the Fourth Circuit in this case. The conflict is between the decision in *Artnell* to remand for findings on the validity of the basis for deferral of income because it was unearned and the absolute prohibition on deferral of unearned income in this case. The conflict lies in the interpretation to be placed on the opinion in *Schlude* v. *Commissioner*, 372 U.S. 128 (1963): Did this Court, in spite of the limited language of the opinion in *Schlude*, mean to lay down as an absolute rule a prohibition on deferral of any unearned income regardless of the accuracy of the taxpayer's accounting method?

The differences between *Artnell* and this case that are cited by the Government (p. 19) have no bearing on the conflict. The conflict arises from the fact that the Court in *Artnell* recognized the *possibility* that the unearned portion of income received in advance could be measured so accurately that the taxpayer's accounting method should not be disturbed.

In its Brief here (p. 19) the Government says that it believes *Artnell* was wrongly decided. In saying this, the Government comes close to admitting that the *Artnell* decision is in conflict with the decision of the Fourth Circuit in this case.

The Government's Brief leaves the impression that the taxpayer's computation of unearned interest income in this case was merely some sort of an arbitrary allocation (pp. 16-17). In fact it was a precise mathematical computation based upon the use of money for an elapsed period of time. The Government has not challenged the accuracy of this computation, or the absolute liability of the taxpayer to refund unearned interest, at any point in the proceedings.

There are serious inaccuracies in the discussion of this

issue in the Government's Brief (G. Br. 16). First, the unearned interest that was also unpaid did not, itself, draw interest before it was earned.[2] Second, there is no basis for the Government's characterization of the unpaid and unearned interest as "capitalized" interest (pp. 16, 18), this evidently being an attempt to retrieve a point the Government conceded before this Court in the *Schlude* case. There the Court said:

> "The Commissioner included in gross income for the years in question not only advance payments received in cash but the full face amounts of notes and contracts executed during the respective years. The Tax Court and the Court of Appeals upheld the Commissioner, but the United States in this Court has retreated somewhat and does not now claim the includibility in gross income of future payments which were not evidenced by a note and which were neither due by the terms of the contract nor matured by performance of the related services.[6]"

"[6] 'Upon reconsideration, however, we concede the error of accruing future payments which are neither due as a matter of contract, nor matured by performance of the related services. Indeed, the Studio's right to collect the installment on its due date depends on its continuing ability and willingness to perform. Until that time, its right to receive payment has not fully ripened.' Brief for the United States, p. 67."

4.

BRANCH OFFICE MANAGERS SUPPLEMENTAL RETIREMENT PLAN

It is abundantly clear that the intent of the law is to give a life insurance company a deduction for a life insurance reserve that it is required by State law to maintain,

[2] This is clear from Finding of Fact No. 101 (App. 66a-67a) and PX 10 (Tr. 591).

the law recognizing that this is a legitimate expense against underwriting income.[3]

The reserves in question were required by the law of North Carolina, and the Company had no choice whatever as to whether it would maintain them or not. The reserves were shown on the Company's annual statements as such and were specifically examined by insurance examiners and approved by them as "life insurance reserves" (Tr. 274-276; 349). Each and every element needed to qualify these reserves as "life insurance reserves" specified in Section 801(b) was met.

There is no basis for the contention in the Government's Brief (p. 27) that the Company could use and invade these reserves at will. The reserves were maintained so long as liabilities existed under the Plan that required their maintenance under State law, and the taxpayer was strictly accountable to the Insurance Commissioners for the integrity of these reserves. The Government's arguments ignore the simple proposition that the reserves comply with the statute and the regulations thereunder. Other considerations are not pertinent to this issue, and the Government should not be allowed to throw out reserves which met in all respects the requirements of Section 801(b).

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[3] In the debate on the 1959 Act in the House of Representatives, Chairman Mills made the following statement:

> "Certainly, it is not the intention of the chairman that that [approval of Secretary of Treasury for change in basis of computing reserves] be required. I think I can speak without fear of contradiction and say it is not the intention of the committee. We are trying to preserve as best we can in this bill the management of this industry in the hands of the State regulatory agencies and not to change in any way that situation so as to turn over to the Commissioner of Internal Revenue, the Secretary of the Treasury, or anyone else in Washington the regulatory authority." 105 Cong. Rec. 2576-2577.

5.

AGENTS' DEBIT BALANCES

Contrary to the Government's Brief (p. 22), the taxpayer does not argue that the agents' debit balances should be excluded from assets because they do not produce investment income. Instead, the taxpayer contends they should be excluded because they are used in carrying on an insurance trade or business and thus qualify for the exclusions written into Section 805(b)(4) in precisely those words.[4]

6.

CONSOLIDATED RETURN COMPUTATIONS

The discussion in the Government's Brief (pp. 29-30) of the issues of the treatment of intercompany dividends and intercompany investment in consolidated returns is based upon the erroneous assumption that intercompany dividends are income to the tax-reporting group. Contrary to the assertion in the Government's Brief (p. 31) that these dividends are a type of tax-exempt income, *these dividends are not income to the affiliated group;* they are transfers of funds within the group. This point was established beyond question in the record of the case (Tr. 160-161, 198-199, 213-214, 244, 261, and 490-491), and the trial court found that generally accepted accounting principles of consolidation required both the elimination of the intercompany dividends and the elimination of the intercompany investment in the stock of the subsidiary. (App. 53a)

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[4] In fact, no interest was charged on any of the balances. There is nothing in the record to support the statement in the Government's Brief (p. 21) that Pilot "apparently" had the right to charge interest on its agents' debit balances. This attempt in the Government's Brief to assume that Pilot had a right to charge interest on the balances owed by its insurance agents assumes some importance when it is realized that approximately 99% of the amounts involved in this issue were agents' debit balances of Pilot.

The Government's Brief on this issue simply fails to recognize that neither income nor assets of the group as a whole are increased by declaring and paying a dividend that transfers funds from one member of the group to another. *United States* v. *Atlas Insurance Co.*, 381 U.S. 233 (1965), did not, of course, involve this situation.

The Government's Brief (pp. 30-31) attempts to reconcile the Court of Appeals holding with the consolidated return regulations that required intercompany dividends to be eliminated. Regs. Sec. 1.1502-31A(b)(1)(i). The attempt fails, however, because the regulations required the intercompany dividends to be eliminated *at the outset*—before any separate company income computations were made. The Government's case, on the other hand, is based upon the contention that the intercompany dividends should be taken into account in computing separate company policyholders' shares so that only the remainder of the dividends will be eliminated at a later stage.

The Government's Brief (p. 28) is in error in stating that both courts below agreed with the Government's position. The District Court below decided this issue in favor of the taxpayer, concluding that the intercompany dividends paid by Pilot to Jefferson were not income and the intercompany investment of Jefferson in the stock of Pilot was not an asset for purposes of the consolidated returns; that the intercompany dividends were properly eliminated from gross investment income in their entirety; and that the consolidating methods and procedures employed by the taxpayer were proper. (App. 88a-89a)

7.

THE 2% ADDITIONAL TAX

For the first time in its Brief in opposition to certiorari the Government clearly states (p. 32) that its contention for

application of the 2% tax imposed by Section 1503(a) to life insurance companies filing consolidated returns is based upon the theory that the surtax rate provided by Section 11(c) is "modified" by Section 1503(a). This interpretation of the relationship between Section 1503(a) and Section 11(c) is contrary to the Government's longstanding administrative interpretation of the 2% tax. It is contrary to the position taken on the tax return forms prepared for use by ordinary corporations filing consolidated returns, and it is contrary to the specific rule laid down in Rev. Rul. 58-246, 1958-1 C.B. 339. Both the return forms and this ruling took the position that, in the case of ordinary business corporations filing consolidated returns, the 2% additional tax imposed by Section 1503(a) applied to the first $25,000 of taxable income of the group as well as to the balance. The surtax rate provided in Section 11(c) did not, however, apply to the first $25,000 of taxable income; in fact, the principal reason for having a surtax separate from the normal tax was in order to exempt the first $25,000 of taxable income from the surtax rate. Thus it is plainly inconsistent for the Government, in this case, to take the position that the surtax provided by Section 11(c) is "modified" by Section 1503(a).

8.

USE OF N.A.I.C. ANNUAL STATEMENT COMPUTATIONS

The Government's Brief (pp. 15 and 33) attempts to set up a straw man by saying that the taxpayer is contending for adoption of the N.A.I.C. form *in toto* and for its use "indiscriminately" for tax purposes. That is not the taxpayer's position. It is the taxpayer's position that Congress meant, by enacting Section 818(a), that the N.A.I.C. annual statement computations should be used, where consistent with an accrual method of accounting, in those

instances in which Congress did not otherwise specify a computation rule by statute.

Notwithstanding the detail and the complexity of the 1959 Act, the statutory language failed to deal specifically with a wide variety of problems. All of the issues to which the taxpayer contends N.A.I.C. computations should apply are those on which the statute is silent. As to such issues the reference to N.A.I.C. annual statement computations raises the same issue as the similar reference in Section 204 of the 1939 Code and Section 832(b)(1) of the 1954 Code with respect to the taxable income of casualty insurance companies—*as to which the Government's Brief (pp. 35-37) concedes a conflict of authority exists.*

CONCLUSION

For the reasons stated above and in the petition, certiorari should be granted.

Respectfully submitted,

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